



Economic Update

Committee on the Budget • Majority Caucus
U.S. House of Representatives
Jim Nussle, *Chairman*

309 Cannon House Office Building
Washington, DC 20515 (202) 226-7270
Jim Bates, *Chief of Staff* • www.budget.house.gov

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Solid Expansion Expected, Policy Challenges Loom

The most recent and updated data confirm that 2004 displayed one of the best performances for the U.S. economy in the past 2 decades – including strong growth in real gross domestic product [GDP] and business investment, rebounding payroll employment, falling unemployment, and robust housing markets.

Looking forward, public and private forecasters expect the economy to continue in a sustained expansion, with solid real growth, ongoing payroll jobs gains, and low unemployment and inflation. Policymakers will face the challenge of gradually unwinding the accommodative policies of the past several years as the economy moves toward full employment. Federal Reserve Chairman Greenspan is scheduled to testify before Congress this week on the future course of monetary policy.

Recent Data

The economic recovery of the past several years resulted largely from several key factors: the inherent flexibility and resilience of the U.S. economy, an accommodative monetary policy with low interest rates, and an expansionary fiscal policy of income and business tax relief. The most recent data reflect these policies and conditions:

- Real GDP grew at a 3.1 percent annual rate in the fourth quarter of 2004 – the 13th consecutive quarter of growth following the economic slowdown and recession of 2000-01. Real GDP grew 4.4 percent in 2004 – the strongest annual performance in 5 years and one of the strongest growth performances of the past 20 years.
- Payroll employment rose by 2.2 million jobs during 2004 and is up by more than 2.7 million jobs since May 2003. In addition, upward revisions showed that payroll jobs growth over 2003-04 was stronger than previously estimated – by about 200,000 jobs. Payroll employment has now more than regained the jobs lost as a result of

the recession. Private forecasters expect jobs gains averaging about 190,000 per month during 2005.

- The unemployment rate fell to 5.2 percent in January – down from 6.3 percent in June of 2003 – and is now lower than the decade averages for the 1970s (6.2 percent), the 1980s (7.3 percent), and the 1990s (5.8 percent).
- Unemployment insurance claims recently have been running at just above 300,000 – the lowest level in more than 4 years, and a sign of likely ongoing solid growth in employment. Claims have been below the 400,000 level for 71 straight weeks. (Claims below 400,000 indicate continued improvement in labor markets.)
- Real business equipment investment has increased at a 15-percent annual rate over the past year and a half – the best performance in 7 years.
- Housing starts and building permits have been running at their highest levels in 20 years – at a pace of about 2 million new housing units per year. The homeownership rate during 2004 reached a record high level (69 percent).
- The international trade deficit, however, also reached a record high in 2004. In many ways, though, the rising imbalance reflects the stronger growth of the U.S. economy relative to weaker growth of many of our major trading partners. Many analysts and some key policymakers expect the trade deficit to stabilize or decline in coming periods.

Economic Outlook

As noted, private and public forecasters are in general agreement that the U.S. economy is in a period of sustained expansion. The accompanying table shows a comparison of the economic projections from a) the Bush administration

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for its fiscal year 2006 budget; b) the Congressional Budget Office [CBO] from its January budget projections; and c) the private Blue Chip “consensus” from February.

- The projections all show continued strong growth in real GDP – in the range of 3.6 percent to 3.8 percent for calendar year 2005 and 3.4 percent to 3.7 percent in calendar year 2006. Real GDP growth is expected to average about 3.2 percent to 3.4 percent over the 2006-10 period.
- Even with the continued solid growth, inflation is expected to remain relatively low. Consumer price index [CPI] inflation is expected to be around 2½ percent in 2005, and in the 2.1-percent to 2.4-percent range over the 2006-10 period.
- The unemployment rate also is expected to remain relatively low – in the 5.1-percent to 5.2-percent range over most of the projection period.

the House and Senate Budget Committees began evaluating policies that will lead to their respective versions of the congressional budget resolution. The process is expected to culminate over the next 2 months in a concurrent budget resolution that will establish the basis for the fiscal year 2006 spending and tax policies.

The Federal Reserve’s Federal Open Market Committee [FOMC] met at the beginning of February and decided to raise its key policy interest rate – the Federal funds rate – to 2.5 percent. The FOMC policy statement said, in part: “Output appears to be growing at a moderate pace despite the rise in energy prices, and labor market conditions continue to improve gradually.” The Fed has now raised rates by 1½ percentage points since last June, reflecting the strengthening economic performance. Fed Chairman Greenspan is scheduled to present the semi-annual monetary policy testimony before congressional committees later this week.

Comparison of Economic Assumptions

	2005	2006	2007	2008	2009	2010	Average 2006-2010
	<i>Percent Change</i>						
Real GDP							
Admin Feb Budget	3.6	3.5	3.3	3.2	3.1	3.1	3.2
CBO January	3.8	3.7	3.7	3.4	3.1	2.9	3.4
Blue Chip (Feb/Oct)	3.6	3.4	3.2	3.2	3.1	3.3	3.2
GDP Price Index							
Admin Feb Budget	1.9	2.0	2.1	2.1	2.1	2.1	2.1
CBO January	1.8	1.5	1.7	1.8	1.8	1.8	1.7
Blue Chip (Feb/Oct)	2.0	2.0	2.1	2.1	2.1	2.1	2.1
CPI							
Admin Feb Budget	2.4	2.3	2.4	2.4	2.4	2.4	2.4
CBO January	2.4	1.9	2.1	2.2	2.2	2.2	2.1
Blue Chip (Feb/Oct)	2.5	2.3	2.4	2.4	2.4	2.4	2.4
	<i>Annual Average, Percent</i>						
Unemployment Rate							
Admin Feb Budget	5.3	5.2	5.1	5.1	5.1	5.1	5.1
CBO January	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Blue Chip (Feb/Oct)	5.3	5.2	5.1	5.1	5.1	5.1	5.1
3-Month Tbill Rate							
Admin Feb Budget	2.7	3.5	3.8	4.0	4.1	4.2	3.9
CBO January	2.8	4.0	4.6	4.6	4.6	4.6	4.5
Blue Chip (Feb/Oct)	3.0	3.9	4.1	4.3	4.2	4.2	4.1
10-Year Treasury Note Rate							
Admin Feb Budget	4.6	5.2	5.4	5.5	5.6	5.7	5.5
CBO January	4.8	5.4	5.5	5.5	5.5	5.5	5.5
Blue Chip (Feb/Oct)	4.7	5.3	5.6	5.6	5.6	5.6	5.5

Sources: OMB, CBO, Blue Chip Economic Indicators (February 2005 and October 2004)

In general, the administration’s and CBO’s projections are very similar to those of the private Blue Chip consensus, and as such, they represent reasonable sets of economic assumptions for budget estimation purposes.

Budget and Monetary Policies

With the submission of the President’s budget on 7 February,

Prepared by **John H. Kitchen**
Chief Economist